

## Internal Revenue Service

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September 05, 2006

### LEGEND:

Taxpayer =

State =

Commission =

Date =

Effective Date =

X =

Director =

Dear :

This letter responds to the request, dated October 11, 2005, of Taxpayer for a ruling on whether it is proper to determine the Taxpayer's revenue requirement using a multi-year average for the historical investment component of rate base but not using a multi-year average for the deferred tax reserve component.

The representations set out in your letter follow.

Taxpayer is an integrated electric and natural gas utility headquartered in State. Taxpayer's business includes regulated utility operations and unregulated energy activities. Its regulated utility operations are subject to the regulatory jurisdiction of Commission with regard to its retail rates and certain conditions of service.

On Date, Taxpayer filed an application for changes to its service rates with Commission. That request used the fiscal year X as its test year and calculated the

“general common plant” component of the rate base using the year-end rate base balances of the assets comprising general common plant. Taxpayer’s proposal reduced this balance to that portion allocable to the State jurisdictional amount. Taxpayer further reduced this amount by the related allocated accumulated depreciation and amortization as well as the related allocated accumulated deferred income tax (ADIT) reserve. These reductions were made using the allocated year-end balances as of the close of X of the depreciation, amortization, and income tax.

Commission staff has proposed that Taxpayer adjust rate base in respect of general common plant so that a historical five-year average is used to determine most of the components of general common plant rather than the end-of-test-year balances. However, while the commission staff recommended that the assets comprising general common plant as well as the depreciation and amortization percentages related to those assets be determined using a five-year average, it did not recommend adjustment of the Taxpayer’s proposal to use the end-of-test year balance of accumulated depreciation or deferred tax reserves. Commission adopted the staff’s recommendation and Taxpayer requested that the Commission reconsider, arguing that use of a five-year average for general common plant and an end-of-test-year balance for ADIT caused a normalization violation. Commission and Taxpayer then prepared this request together. However, Commission also approved, as of Effective Date, a revised tariff using five-year averages for assets comprising general common plant and an end-of-test-year balance for deferred tax reserve and accumulated depreciation component of rate base. Because of the ruling request, the revised tariff was not finalized by Commission.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under section 168 shall not apply to any public utility property (within the meaning of section 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, section 168(i)(9)(A)(i) of the Code requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under section 168(i)(9)(A)(ii), if the amount allowable as a deduction under section 168 differs from the amount that would be allowable as a deduction under section 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under section 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) of the Code provides that one way the requirements of section 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under section

168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under section 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former section 167(l) of the Code generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former section 167(l)(3)(G) in a manner consistent with that found in section 168(i)(9)(A). Section 1.167(1)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(1)-1(h)(1)(i) of the regulations provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(1)-1(h)(1)(iii) of the regulations provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used.

Section 1.167(1)-1(h)(2)(i) of the regulations provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under section 1.167(1)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under section 167(a).

Under § 1.167(1)-1(h)(6)(i), the reserve excluded from the rate base must be determined by reference to the same historical period as used in determining

ratemaking tax expense. A taxpayer may use historical or projected data in calculating these two amounts, but they must be done consistently.

Section 203(e) of the Act provides another way in which a normalization method of accounting is not being used for public utility property.

According to section 203(e)(1) of the Act, a normalization method of accounting shall not be treated as being used with respect to any public utility property for purposes of section 167 or 168 of the Code if the taxpayer, in computing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, reduces the excess tax reserve more rapidly or to a greater extent than this reserve would be reduced under the average rate assumption method (ARAM).

The term "excess tax reserve" is defined in section 203(e)(2)(A) of the Act as the excess of:

(i) the reserve for deferred taxes as described in former section 167 (1)(3)(G)(ii) or 168(e)(3)(B) (ii) of the Code as in effect on the day before the date of the enactment of the Act, over;

(ii) the amount that would be the balance in this reserve if the amount of the reserve were determined by assuming that the corporate rate reductions provided in the Act were in effect for all prior periods.

Section 203(e)(2)(B) of the Act defines the ARAM and explains the calculations under this method. ARAM is the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its books of account that gave rise to the reserve for deferred taxes. Under the ARAM, if timing differences for the property reverse, the amount of the adjustment to the reserve for the deferred taxes is calculated by multiplying:

(i) the ratio of the aggregate deferred taxes for the property to the aggregate timing differences for the property as of the beginning of the period in question, by;

(ii) the amount of the timing differences that reverse during this period.

Rev. Proc. 88-12, 1988-1 C.B. 637, provides further guidance as to the application of the ARAM to the excess tax reserve. Section 2.04 of Rev. Proc. 88-12 provides that under the ARAM, excess tax reserves pertaining to a particular vintage or vintage account are not flowed through to ratepayers until such time as the timing differences in the particular vintage account reverse. Moreover, it is a violation of section 203(e) of the Act for taxpayers to adopt any accounting treatment that, directly or indirectly, circumvents the rule set forth in the previous sentence. Section 2.04 also

provides that section 203(e) of the Act does not modify the normalization requirements of former section 167(l) or section 168(i) of the Code.

Sections 3 and 4.01 of Rev. Proc. 88-12 provide that a taxpayer who lacks sufficient vintage account data necessary to apply the ARAM, can use the "Reverse South Georgia Method." In general, a taxpayer uses that method if it (a) computes the excess tax reserve on all public utility property included in the plant account on the basis of the weighted average life or composite rate used to compute depreciation for regulatory purposes, and (b) reduces the excess tax reserve ratably over the remaining regulatory life of the property.

For a public utility to use accelerated depreciation in determining its federal income tax liability, section 203(e) of the Act requires that normalization accounting be used to reduce the excess tax reserve in calculating the rates to be charged the utility's customers and in maintaining the regulated books of account. Under section 203(e) of the Act, the immediate flow through of the excess tax reserve to the utility's customers is prohibited. Instead, the excess tax reserve is to be reduced and flowed through to cost of service no more rapidly than this reserve would be reduced under the ARAM, or, where appropriate, the Reverse South Georgia Method.

Section 203 (e) of the Act limits the rate at which the excess tax reserve may be reduced and flowed through to the utility's customers in setting rates. It does not require the utility to flow through the excess tax reserve to its customers, but permits the utility to do so provided the reduction to cost of service is not more rapidly than would be under the ARAM. Thus, section 203 (e) of the Act imposes a limitation on when the excess tax reserve may be returned to the utility's customers in the form of reduced rates.

For purposes of properly accounting for any deferred taxes, § 168(i)(9)(B)(ii) provides that ratemaking estimates or projections of tax expense, depreciation expense, and the reserve for deferred taxes must be consistent with each other and with the estimate or projection of rate base. Thus, the use of a five-year average for determining certain components of rate base and not using that average for the deferred tax reserve component, but rather using an end-of-test-year amount for the deferred tax reserve component, as proposed by Commission, violates the normalization consistency requirement of § 168(i)(9)(B). The Commission has approved, as of Effective Date a tariff, pending the outcome of this ruling request, that is inconsistent with the conclusions reached herein. In our view, finalizing the tariff by issuing a new rate order correcting the calculations in accord with the foregoing prospectively only, without providing for rate relief from Effective Date, would trigger a normalization violation back to Effective Date and the violation would continue until the new rate order was issued consistent with the requirements of § 168(i) of the Code. The new rate order must be consistent with the requirements of § 168(i) in order to comply with the provisions of § 168 and for Taxpayer to remain eligible to use a normalization method of accounting.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman  
Senior Technican Reviewer, Branch 6  
(Passthroughs & Special Industries)